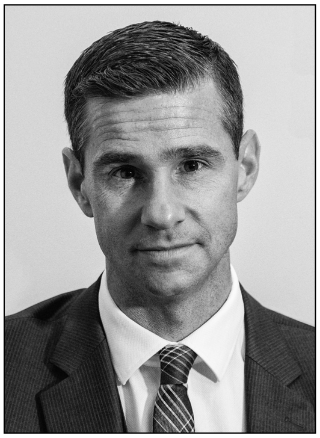
Portfolio Management Commentary

Quarter Ending March 31, 2017



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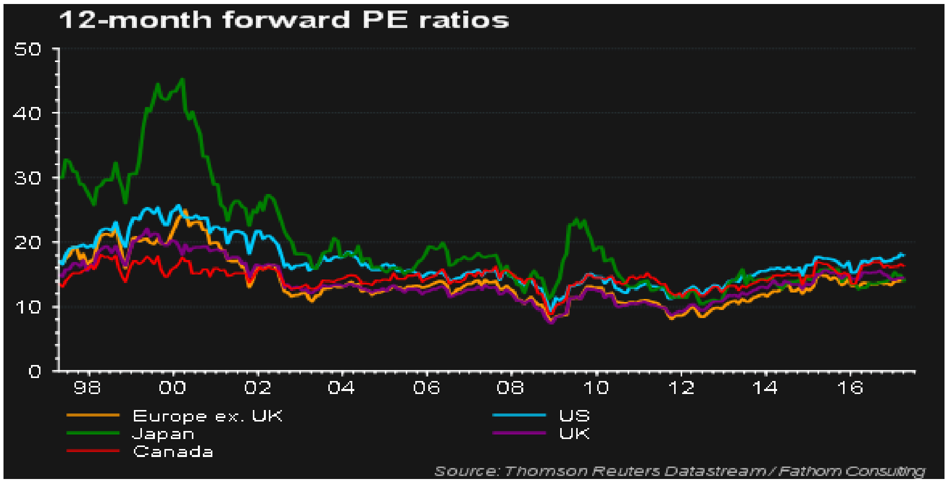
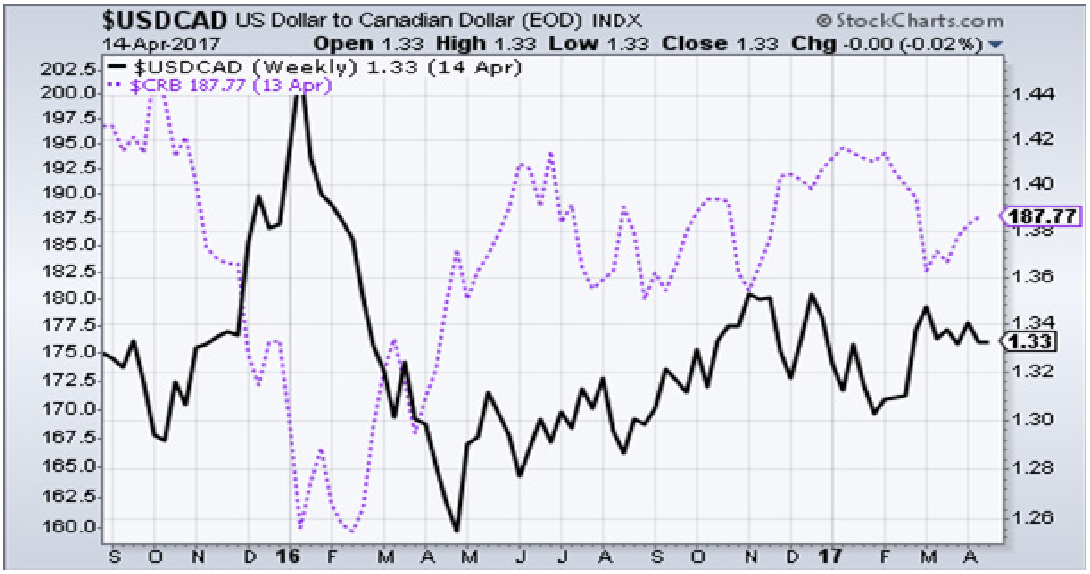
Inside This Issue

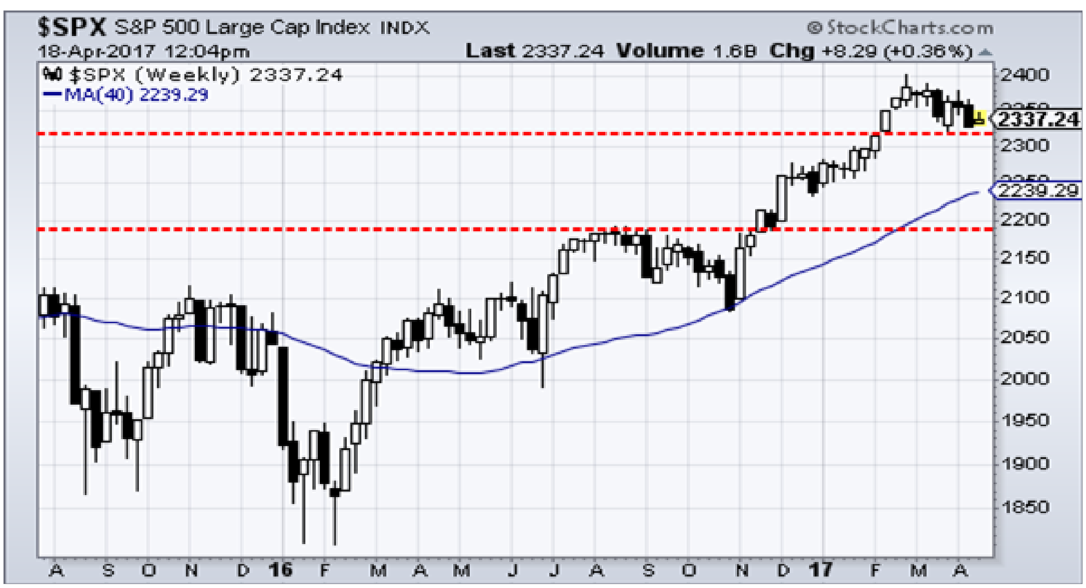
We begin with a thorough review of the past quarter. The concern over market valuations has not abated and so we start by examining forward PE ratios for the major developed regions. As you can see, the appreciation in stock prices and the lack of earnings growth over the past five years has pushed PEs to pre-crisis levels. On its own this may seem alarming, but in conjunction with forward earnings growth projections the picture improves. A place to focus on is the trough in 2016. Since oil has stabilized in price, earnings growth forecasts have rebounded nicely. It is no surprise that the greatest recovery is in Canada where energy accounts for 22% of the index weighting. Of course, this cyclicality has its drawbacks as revisions tend to be more volatile in their amplitude than for the US or the eurozone. Regardless, forward earnings growth is needed to temper the rise in price or buyers will seek more attractive alternatives. At the moment, the equity market is the most attractive option, but we need to be mindful of any changes to the above relationships.



The USD/CAD dollar cross is always relevant to us here in Canada. The black line below shows the path of US dollar relative to the Canadian. Since September of 2016, the currencies have traded in a band between $1.30-$1.35. Also plotted on this chart are commodities as represented by the $CRB. Notice the inverse relationship between the price of commodities and the strength of the USD. Commodities have been range bound between 182.5 and 195 since May of last year. Given the uncertainty in US fiscal and monetary policy and the consolidation patterns of the FX pair and the $CRB, I believe both points will be constrained in their ranges for the time being.

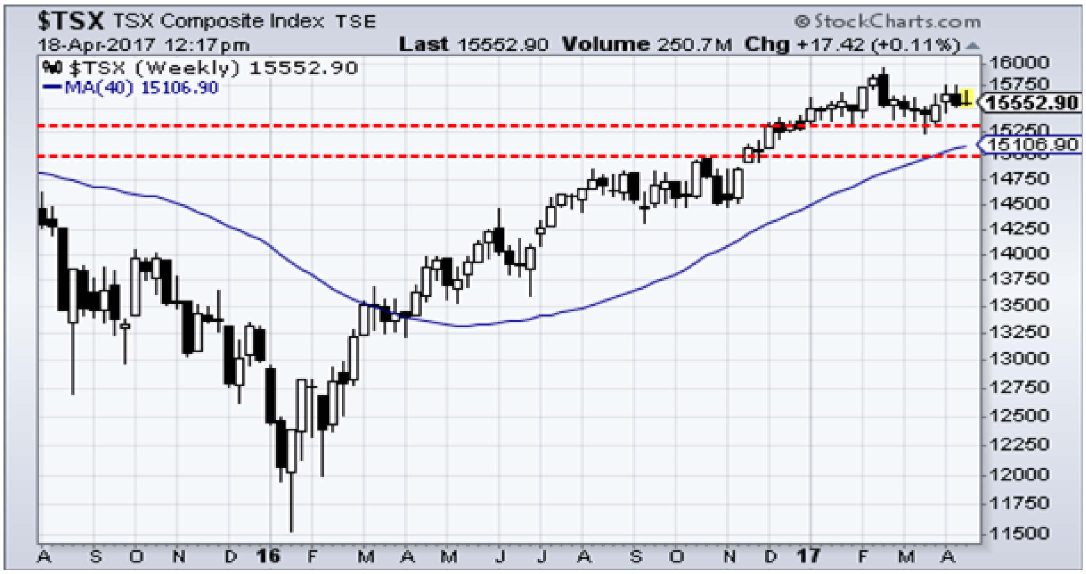


We have seen additional strength in the US and Canadian broad based markets since the end of 2016. As you can see below, the $SPX has pushed higher and new support exists around 2300. Given the most recent geopolitical tension with North Korea, the $SPX advance has paused as market participants gyrate their bets with very short term trading strategies. Clearly a pause is warranted as all investors need to digest the impact of earnings season, warfare, and political disunity in the White House.



The $TSX has had a more subdued advance since the start of 2017 as commodities retreated from their highs back in February. Regardless, a new shelf of support has emerged around 15,300 for the index. After the dramatic rise from the 2016 lows, it makes complete sense that, as Jeff Saut says, the market needs to rebuild its internal energy before meaningful, future progress can be made. While this comment was not directed to the $TSX's price performance, it certainly applies.

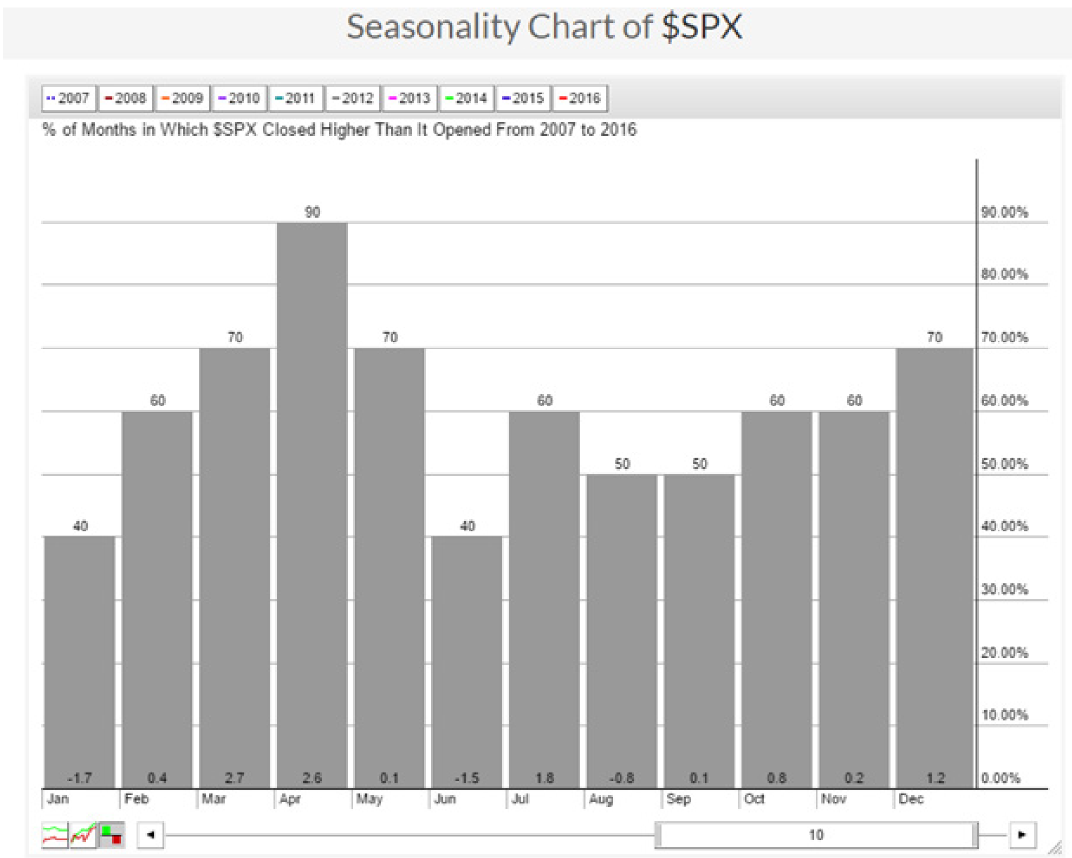
Special attention should be paid to the 40 week moving average as that marks support for the next leg down.



Because we live in a global community it makes sense to review international markets as well. The MSCI EAFE index tracks Europe, Asia, and the Far East, and an analysis of its price action provides a more complete picture of global financial market health.

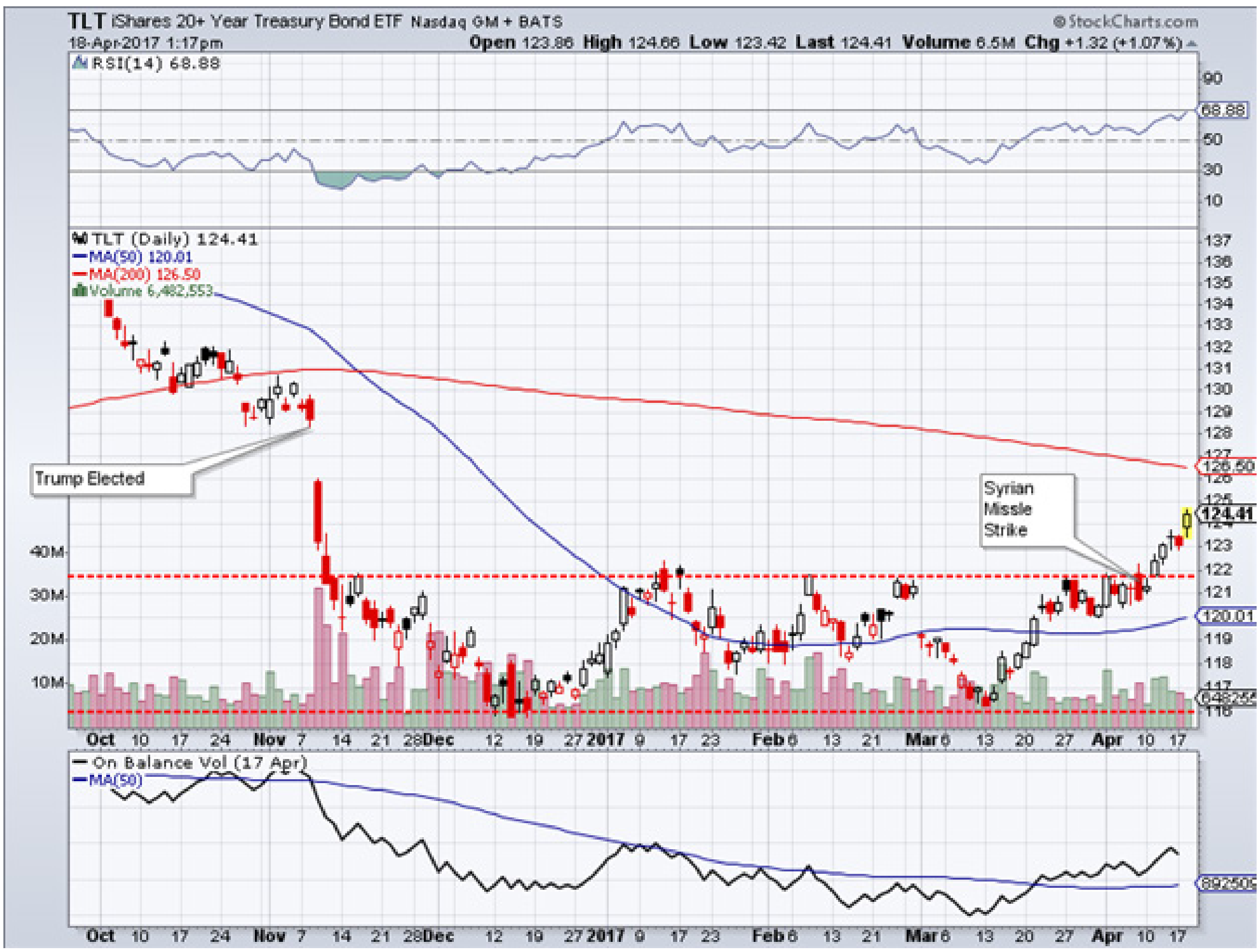
Here is my interpretation of the chart. 2017 has been a very strong year for international markets. In fact, the EFA, an EFT which tracks the index, posted 11 straight weekly gains since the start of the year. Not bad at all! The ADX on the bottom of the chart shows the strength of the trend and its direction. When the black line points up then the market is trending. The steeper the slope, the greater the trend. The green and red lines are the direction of the trend. Green means up, and red means down. Right now, the EFA is in a strong upward trend, but we need to be mindful of the relationship between the green and red line. If the red line starts to accelerate to the upside then the negative trend is increasing in momentum and we need to be defensive.

Here is a quick visual update on monthly seasonality for the $SPX. As you can see, for the 10 year period ending December 31, 2016, April has the highest probability of posting a positive return.



I also ran the analysis back to 1990, with rolling 10 year periods, and the data confirms that April is a consistent performer. Of course, this is only a seasonal tendency and not an absolute. In any event, it is a piece of useful analysis which may help us downplay inter-monthly sell-offs if there is a high tendency for prices to reverse to the upside.

A quick note on bonds. The below chart is the long term (20+ years) US bond index. As you can verify, long bond prices got hammered when Trump was elected. Why? He is seen as the pro-inflation president and his policies are interpreted as pro-growth. The market sees this as positive for stocks and negative for bonds, especially long maturities, as interest rates rise in sympathy with improving economic and corporate conditions. What is most intriguing is the breakout in long bond prices since the US missile strike on Syria on April 7, 2017. The TLT has been in a trading range since the middle of November. The breakout in early April may signify a rotation by market participants back into long term Treasuries to mitigate stock market risk. However, assuming a Fed committed to raising rates, this strategy may prove to backfire as long bond prices will decline as rates rise. It is important to monitor this relationship, however, as capital flows can cause distortions in the pricing of securities.



Your Portfolio

It should come as no surprise that the first quarter of 2017 was positive for all portfolio models. While the global nature of our asset allocation can underperform at times, its diversity and risk control aspects also help it shine in periods of uncertainty. As the market continues to digest the ongoing assault of disturbing news, I suspect we shall see a correction. I see this as a constructive development because momentary sales in share prices allow us to upgrade the quality and strength of our portfolios. Of course, a correction is one thing and a trend change is something quite different. In the event of a pronounced market move to the downside, risk controls are utilized to reduce the drawdown and protect capital. This is why we have stop-losses on security positions. The corollary in everyday life is the seatbelt in your car. It may be annoying, but its designed to protect against catastrophe.

There were no positional changes in Q1 2017. I am a firm believer that when something is not broken then there is no need to fix it. There was nothing that needed fixing for the first three months of this year. Please keep in mind that just because there were no trades, that doesn't mean that I was idle in my PM duties. Quite the contrary. Time was spent on adjusting stop-losses, tracking new potential trades, checking correlations, reviewing fundamental research on existing positions, comparing intermarket analysis, and updating technical charts. All of these activities combine into a "weight of the evidence" approach which drives specific portfolio buys and sells. Strangely enough, the best course of action is to wait until the right environment presents itself and then take specific action.

Final Thoughts

It is my contention that risk is not being properly priced into the market at the moment. The $VIX, a measure of implied volatility in options, seems to be out-of-step with the headline risk of geopolitics. Given the potential ramifications of military action, trade wars, and populism, I thought the $VIX should be trading in the 20s versus the 14s. Of course, a market that does not want to roll over is a good thing and should not be fought. The two famous axioms of Wall Street are important to remember: Don't fight the Fed and don't fight the tape. It is with all of this in mind that I am focused on staying with the upward trend of the market, but with an eye towards identifying risks that could impede our progress. I wish you all of the best in the quarter to come.